

2000 PREAUDIT PROCEDURES

The preaudit phase is vital to the audit process. This is the phase where the auditor determines whether to proceed with the examination or accept the returns as filed. If the determination is made to proceed, this is also the phase where the auditor plans the audit and performs the preliminary work. Proper attention to the preaudit procedures will improve the quality of the audit and help reduce total audit time.

The preaudit steps discussed in this section are fairly universal for all multistate audits. Once specific audit issues have been identified, the preaudit procedures may be expanded to specifically address those issues.

Care should be taken to keep an open mind throughout the preaudit phase. The information available during this phase is seldom sufficient to make any conclusive determinations. By becoming prematurely convinced of the outcome of issues, auditors can fall into the trap of only gathering information that supports a predetermined conclusion.

Reviewed: December 2002

2100 REVIEW OF TAX RETURNS UNDER AUDIT

The auditor should review all parts of the return in detail. The purpose for this review should be to become familiar with the return, and to make a preliminary identification of audit issues. Special attention should be paid to audit instructions transmitted on FTB Form 7024, *Request for Field Action*, and other data transmitted with the returns or contained in the audit file. Auditors should ensure that they have obtained all amended returns for the taxable years being addressed.

As the returns are being reviewed, auditors should take preliminary notes to record any questions or potential audit issues. Many of the questions contained in these notes will be resolved as the auditor progresses further through the preaudit procedures. Any remaining questions are issues that may be incorporated into the audit plan. For easier workpaper reference, notes on each subject matter should be started on a new page. For example, any notes on the property factor should be on a separate sheet from notes concerning the payroll factor. When the working papers are assembled in final form, the notes can then be included in the appropriate workpaper section.

If the auditor encounters any unfamiliar issues on the return, preliminary research should be conducted to become familiar with the issue. Such research during the preaudit stage will assist the auditor in determining the audit potential of an issue, and in planning the audit procedures, questions and types of records necessary to develop the issue.

Certain industries have unique issues and may require special apportionment rules. In such cases, research of the industry should be conducted in addition to research of the particular tax return items. Information on several industries that require special apportionment treatment is included in MATM 7700 - MATM 7815. FTB also has a separate manual for Banks & Financials.

The Water's-Edge Manual is available to assist auditors in identifying issues.

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2110 Domestic Disclosure Spreadsheet For Pre-1994 Years

Prior to 1994, water's-edge taxpayers were required to file a domestic disclosure spreadsheet (DDS) if the total assets of the related group exceeded \$250 million, or if the total property, payroll or sales in foreign countries exceeded \$10 million (a de minimis exception applied if the property, payroll and sales within the U.S. were each less than \$500,000) (former §25401(d)). The DDS requirement was repealed for taxable years beginning on or after January 1, 1994.

The DDS was useful for identifying the taxpayer's affiliates and understanding the ownership chain. Auditors should be aware, however, that the information disclosed on the DDS was not necessarily accurate. Therefore, although the DDS should have been obtained when practical as a starting point for identifying unitary issues, the auditor should have also corroborated that information through other sources such as SEC filings and corporate directories. However, since years have passed since the repeal of the DDS filing requirement, the information on a pre-1994 DDS may no longer reflect the ownership structure for the year under audit, if auditing a post-1993 year.

Eventhough the DDS filing requirements have been repealed, the auditor should obtain the DDS if a pre-1994 year of a water's-edge taxpayer is under examination and the taxpayer had a DDS filing requirement. For audits of post-1993 taxable years, auditor judgment should be used in determining if ownership information contained on an old DDS would be useful for preliminary analysis of unitary issues or other issues present for the taxable year under audit. It may be more feasible to look to other information sources that may provide pertinent information.

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2200 REVIEW OF PRIOR AUDITS

Prior audit reports, protests, and appeal files should always be reviewed. If a copy of the prior audit report is not retained in the program office or associated with the returns, it should be requested. Not only should the prior audit report help identify prior year adjustments which may be applicable to the current years, it should also help determine the extent of the audit scope. For example, if the sales factor numerator was extensively tested in prior years and no adjustments resulted, it might be possible to minimize the testing in the current years if business operations have not changed. Also, if an audit adjustment was made in prior years, the auditor **may** be able to use the factual development from the prior audit as a roadmap to streamline the verification of current year facts by directing the auditor's focus to the key areas. Although you may use the prior audit as a roadmap, audits that are based solely upon facts developed in a prior audit cycle without adequate factual development for the current period are not acceptable. This policy applies to unitary adjustments and any other issues that recur over more than one audit cycle. **The facts for the current audit cycle must be fully developed unless the taxpayer advises the auditor they agree with the adjustment. In such cases, if the taxpayer is willing to sign a statement confirming their agreement, there is no reason to require the taxpayer to undergo an extensive examination of the issue for the current years. (See MATM 2225 and MATM 2800).**

IMPORTANT: Prior audit reports can help to streamline the audit process and avoid duplication of efforts between audit cycles. On the other hand, improper reliance on a prior audit can result in audit adjustments that are unsupported. Judgment needs to be used in determining the degree of additional information that will be needed for the current years, and the auditor needs to keep in mind that facts often do change from year to year. Also, court decisions or changes in the statute or regulations can reverse prior interpretations.

Once the auditor has determined that some reliance may be placed on facts developed in the prior audit report, the auditor must determine the amount of additional information that will be necessary for the current cycle. If a unity issue was fully developed in the prior audit, the amount of additional information required to be verified may be limited. For example, such items as updating the amounts of intercompany sales, updating the amounts of intercompany financing, updating the number of personnel transfers between corporations, and addressing any new unitary ties may be all that is necessary. In other cases, the auditor will need to more fully develop weak facts or facts that were not addressed in the prior audit.

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2225 Reliance On Prior Audits

Generally, auditors may not rely solely upon facts developed in a prior audit cycle. An exception may be made in cases where the taxpayer agrees that the prior year facts are applicable for the current years and agrees to the adjustment. The agreement must be included in a statement signed by an officer of the taxpayer (See MATM 2800).

Prior year audit results should only be used as a starting point, not as the primary basis for an audit recommendation on the current audit cycle. Although auditors should strive to achieve consistent treatment from year to year (as long as the taxpayer continues to operate in the same manner), prior year determinations that were incorrect or based upon incomplete information should not be followed. The facts for the current cycle must be developed because facts often do change from year to year. Independent development of the current year facts will prevent an adverse protest or appeal resolution of the prior years from automatically applying to both audits, especially if the factual record for the current cycle is even stronger than in the prior cycle. For example, if the auditor can develop a more compelling case for unity in the current audit cycle, then the current audit may be sustainable even if the prior cycle was not. Assume, for example, that a prior audit found a taxpayer to be unitary with its affiliate based on strong centralized management as evidenced by internal memos, committee minutes, management reports, and documentation concerning centralized departments for various functions. If the auditor for the current years merely obtains a letter from the taxpayer confirming that the relationships between the corporations are the same as in the prior years, then a protest determination that the corporations are not unitary in the prior years will probably require that the current year adjustment also be withdrawn. On the other hand, by developing the current year facts, the auditor may discover that the level of management interaction has increased. Or, by discussing the case with the hearing officer, the auditor may learn that the taxpayer's arguments have minimized the importance of unitary ties such as centralized departments, so the auditor may be able to strengthen the case by focusing additional attention in the current years to developing the benefits realized through the centralized services.

Even if the prior audits are not being protested, the auditor should develop the current year facts rather than relying on facts developed in the prior audit. Otherwise, if the taxpayer decides to protest the current year determination, the audit adjustments will not be adequately supported. A hearing officer needs specific evidence in order to sustain a protest case; unsupported statements indicating that particular facts exist are neither persuasive nor reliable, and are not generally sufficient to support audit determinations.

Note: When audit determinations are not consistent with prior periods, the reasons for the change in position must be clearly explained to the taxpayer. Auditors need to develop the current year facts in order to arrive at the correct determination for the current period. In some cases, changes in the underlying facts or in the relevant case law may cause an auditor to reach a conclusion for the current years that is different from the determination reached in the prior period. In other cases, the auditor may conclude that an adjustment is appropriate for the current period even though the prior year adjustment was based upon incomplete information, or has been modified, or withdrawn at protest. This situation sometimes occurs when the significance of an issue has increased over the years. For example, assume that no material tax effect would

have resulted from decombination of a newly acquired corporation in the prior audit cycle. The prior auditor, therefore, made a few general observations regarding possible unity, and allowed the newly acquired corporation to be included in the group. In the current years, however, inclusion of the subsidiary has a significant tax impact. In this type of situation, following the prior audit determination without independently developing the facts would be inappropriate because the prior audit did not adequately develop this issue. (This example also illustrates the importance of informing taxpayers when issues that were included in the scope of the audit are accepted without being fully examined. In such cases, the taxpayer should be warned that no determination with respect to the issue has been made, and that the issue is subject to audit in subsequent years.) To avoid a perception that the department is being inconsistent in those situations, the auditor must clearly explain why the current year determination differs from the prior period outcome. This explanation should be included in the closing letter to the taxpayer.

In some cases, an audit issue will not be material enough in the current audit cycle to warrant the resources that would be necessary to develop the facts regarding that issue. If that is the case, then the auditor should inform the taxpayer that the issue is not being included within the scope of the current year examination. When evaluating the materiality of the issue however, consideration should be given to the fact that audits are usually far less time-consuming in the subsequent cycles because the prior audit can be used as a roadmap that will direct you to the key areas to focus on, the specific documents that were found to be relevant, etc. Therefore, the materiality threshold for the subsequent audit of an issue will generally be lower than it would be for an initial examination of the same issue. In unusual circumstances, cases may arise where it will be beneficial to achieve consistent treatment of a unitary issue from year to year, but the materiality of the issue for the current audit cycle is not sufficient to justify an extensive examination. For example, assume the prior audit cycle combined a particular subsidiary, but the issue of combining the subsidiary in the current audit cycle is not material enough to warrant pursuing. On the other hand, you have discovered that the subsidiary was sold after the current audit period, so it will be necessary in the next audit cycle to determine the business or nonbusiness character of the stock gain or loss. (A similar situation could occur if, in a later year, the subsidiary paid a large dividend out of E&P of the current audit period, because the dividend would only be subject to elimination under R&TC §25106 if the subsidiary were included in the combined report when the E&P was incurred.)

On a case-by-case basis, it may be acceptable in these types of situations for the auditor to obtain the taxpayer's agreement that the current year facts are the same as in the previous audit cycle. This agreement as to the facts can be obtained even if the taxpayer does not agree with the auditor's conclusion itself. If you believe that you have a case in which this exception would be appropriate, contact the Manager of Technical Resource Section so that the circumstances of the case may be evaluated before the taxpayer is approached regarding the agreement.

Reviewed: December 2002

2300 COORDINATION WITH PENDING PROTESTS, APPEALS, ETC.

Generally, action pending on the prior years will not preclude the auditor from beginning the current audit. In addition, a pending protest for prior years is not an acceptable reason for delaying an audit. Some taxpayers will resist providing information to an auditor until the prior year protest is resolved. As time passes, taxpayer personnel often change and information is no longer available or becomes much harder to retrieve. Therefore, the audits become more difficult for both the taxpayer and the auditor, and the ultimate development is often much less satisfactory. Auditors should explain to the taxpayer that each year stands on its own facts and should be prepared to issue demands and the failure to furnish information penalty if necessary.

Whenever prior years are still being worked, however, the auditor will need to be familiar with the status of the action and how the issues and possible resolutions of the prior audit report might affect the current years under audit. In addition, auditors are strongly encouraged to contact the hearing officer or attorney assigned to the case. By discussing the case, the auditor can learn the direction in which the hearing officer or attorney is headed with an issue and can plan the audit accordingly. The auditor can also inquire about any weak areas in the prior audit that have been identified by the hearing officer or attorney, and can make sure that those areas are strengthened in the current cycle.

If prior years have been resolved at the protest or appeal level, auditors must be aware of following final determinations without discovering the basis for those determinations. Occasionally, a Notice of Proposed Assessment will be revised or withdrawn at the protest or appeal levels because of lack of factual development in the file to support the audit position. This resolution will not prevent the auditor from fully developing the issue in the subsequent years and recommending appropriate adjustments.

NOTE: ((* *)) = Indicates confidential and/or proprietary information that has been deleted.

Reviewed: December 2002

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2400 REVIEW OF PUBLIC INFORMATION

By taking advantage of the public information that is available, a great deal of preliminary information can be gathered during the preaudit stage. Although the auditor should confirm information received from public sources before any adjustments are proposed, public information is invaluable for identifying issues and for determining the audit-worthiness and potential tax effect of unity issues. Since time at the taxpayer's location is limited, public information can also enable the auditor to complete a good deal of the groundwork prior to arriving at the taxpayer's place of business.

Much of the public information available can be obtained through the program office libraries, Lexis/Nexis and other databases, the state library, and other public libraries.

The auditor may choose to request documents such as annual reports or SEC Form 10-Ks directly from the taxpayer. If, after reviewing the information provided by the taxpayer, the auditor decides that the returns are not good candidates for audit, a letter should be sent to the taxpayer informing them that an examination will not be conducted at the present time, but that the returns are still subject to audit at a later date.

The next few sections describe some of the most common sources of public information.

Reviewed: December 2002

2410 Annual Reports

Companies that trade their stock on any United States exchange supply their shareholders with a copy of the annual report. Annual reports provide a good background on the business operations of the taxpayer, and often comment on management goals, major acquisitions or dispositions, transfers of key personnel, flows of goods and other interaction between the affiliated entities. This information can serve as a starting point for a unitary investigation.

The financial statements that accompany the annual report are an excellent source of financial data for preaudit test checks. In addition, the notes to the financial statements often disclose unusual transactions or accounting adjustments such as additions to reserves or asset writedowns. A review of the notes can be useful in identifying potential audit issues.

Reviewed: December 2002

2420 Sec 10-Ks And Other Sec Filings

The Securities and Exchange Commission requires a variety of filings that may provide extensive unitary and financial information. Following are some of the more common filings that may be of use to the auditor:

Form 10-K

Publicly traded corporations are required to file an annual SEC 10-K with the Securities and Exchange Commission. Although much of the information found in a 10-K is similar to the information included in the annual report, there are some significant differences. Annual reports tend to be written from a public relations perspective, and may contain comments regarding the centralization or integration between the affiliates, or similar subjects with unitary implications. On the other hand, the 10-K will usually contain more detail of the business activities and financial data than is generally disclosed in the annual report. Consequently, the auditor should review both the annual reports and 10-Ks.

SEC 10-Ks may provide a detailed description of the corporation's divisions or lines of business. Often, they also identify the geographic regions where the taxpayer's property and markets are located. This data should be noted and may be useful in identifying potential nexus or throwback sales issues. For example, assume a company has divisions in California and Oregon. The 10-K might discuss the business activity of each division and also disclose that the Oregon division makes sales to customers in Washington, Oregon and California. This information should alert the auditor that some of the total Oregon division sales should be in the California numerator.

The SEC 10-K contains a list of the exhibits that were included in the filing. The auditor should review this list and request any of the exhibits that may be relevant to the examination.

Form 10-Q

The 10-Q is the quarterly report required to be filed with the SEC. The 10-Qs are also filed as transitional reports when the registrant changes its fiscal year-end. Although the data in these reports is unaudited, the Form 10-Qs may be useful in preparing fiscalization calculations or in other situations where interim financial data is necessary.

Form 8-K

The 8-K is titled the Current Report, and is used to report significant events that are deemed to be of importance to securities holders. Reports concerning the following types of events may be of particular assistance to auditors:

- When significant acquisitions or dispositions of assets occur other than in the ordinary course of business, the registrant is required to file an 8-K with a description of the transaction and the assets involved, the nature, amount and source of consideration given or received, and any material relationships that existed between the registrant and the other party to the transaction. If the registrant acquired plant, equipment or other physical property, the 8-K will disclose the nature of the business in which the assets had been used, and whether the registrant intends to continue such use or intends to devote the assets to other purposes. The filing requirement is triggered whether the acquisition or disposition has occurred due to purchase, sale, lease, exchange, merger, consolidation, assignment, abandonment, destruction, etc. Information reported on the 8-K may be valuable for verifying basis or computing gain with respect to assets that have been acquired or disposed of; and also may provide some clues to pursue in an instant unity or business/nonbusiness examination.

- When a change in control of the registrant has occurred, information must be reported concerning the details of the transaction (including the amount and source of the consideration used), the basis for the control, and the percentage of voting securities of the corporation owned directly or indirectly by the controlling shareholder(s). This information may be useful for determining whether unity of ownership exists in complex ownership structures.

Form 20-F

Form 20-F is the annual report required to be filed by foreign companies whose securities are registered with the SEC. The report is similar to the Form 10-K used by domestic entities and should be requested in lieu of the 10-K in foreign parent cases. For purposes of the Form 20-F, the financial statements must either be prepared in accordance with GAAP, or must disclose the variations from GAAP and contain a schedule, which reconciles income statement and balance sheet items to the amounts that would have been presented if GAAP had been used. This information is useful for reconstructing worldwide income for foreign-owned groups (see MATM 5120).

Schedules 14A and 14C

Whenever a corporate action is taken which requires the authorization or consent of the shareholders, an information statement must be provided those shareholders. If proxies are solicited, the information statement is filed on Schedule 14A. Schedule 14C requires substantially the same information as 14A, but is used when proxies are not being solicited. Transactions that may be subject to shareholder approval include mergers and major acquisitions of stock or assets. The information statements will often contain information regarding the reasons for the transactions that may be useful in a unitary examination. The 10-Ks and 10-Qs filed by the registrant should identify whether there have been any matters submitted to a vote of the shareholders for which a Schedule 14A or 14C would have been required.

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2430 Corporate Directories

Moody's Industrial Manuals and similar corporate directories provide brief descriptions of the business activities, corporate histories, lists of affiliates, summaries of financial statement data, and similar information. These directories are useful for identifying affiliates that may not have been included in the combined report, and for gleaning financial data for test combinations (see MATM 2530). Some of the directories specialize in certain areas (such as international companies), and may therefore contain more detailed information than some of the more generalized directories. Auditors should become familiar with the various directories available in their office or public library, and the types of information that those directories offer. Following is a list of some of the corporate directories that are available:

- Moody's Investors Service
- Standard & Poor's Corporations
- Hoppenstedt International Reports
- Directory of Corporate Affiliations
- Japan Company Handbook
- Janes Major Companies of Europe
- Diamonds Japan Business Directory
- Directory of Foreign Firms Operating in the U.S.
- Funk & Scott Index to Industries & Corporations
- Directory of Japanese Companies in the U.S.A.

Reviewed: December 2002

2435 Business Periodicals & Trade Journals

Business periodicals and trade journals are often a good source of information about a taxpayer. Articles in these publications may cover anything from the business activities and history to the CEO's management style to the technologies that are utilized in production to the reasons behind the acquisition of a subsidiary. Information contained in periodicals is not written in a tax context, and may be misleading or incorrect in some respects. On the other hand, such articles can provide good background information and may produce leads for the auditor to pursue further during a unitary investigation.

Publications such as the Wall Street Journal and New York Times publish indexes identifying the companies that have appeared in articles. Many libraries will also have business periodical indexes that reference articles in a variety of publications. For taxpayers in specialized industries, trade journals are a good source for finding articles on even relatively small companies.

The Harvard School of Business distributes a catalog of research papers, which have been written by its students. The papers are indexed by company name, and the catalog contains a brief description of the subject matter of each paper. The papers may be ordered for a relatively low cost. As with other third party articles, the information in the papers should not be relied upon as a basis for an audit determination, but it may provide valuable leads for the auditor to pursue.

Reviewed: December 2002

2440 Industry & Business Ratios

Auditors may consider performing an analysis of the taxpayer's financial ratios against the average ratios for the industry. Some sources for obtaining industry averages are:

- Dun & Bradstreet Industry Norms & Key Business Ratios;
- Robert Morris Associates Annual Statement Studies; and
- Almanac of Business and Industrial Financial Ratios by Leo Troy, PhD.

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2445 Lexis/Nexis

There is a tremendous amount of information available through LEXIS/NEXIS, and once an auditor becomes familiar with the service, its use can greatly cut down on preliminary research time while providing access to a tremendous array of research materials.

Use of LEXIS/NEXIS is encouraged as a standard procedure in multistate audits. It is a very powerful research tool.

Some pointers for finding taxpayer information on the LEXIS system include:

Search more than just the taxpayer's name; search the parent corporation, affiliates and top corporate officers.

Use the combined (two or more) libraries whenever possible; the focus can always be narrowed later. The "COMPNY" library is the most widely used by auditors, and is an excellent source for background information.

LEXIS customer service is available to answer questions about the system and to provide assistance in putting together searches and selecting libraries and files. The phone number is 1-800-543-6862.

The following table contains suggestions for locating specific types of information on LEXIS:

IF YOU WANT TO FIND:	SEARCH CRITERIA	SEARCH LIBRARY/FILE
Business and financial information on the taxpayer	Taxpayer	COMPNY/COMPNY NEWS/ALLNWS
Background of executives	Executive name	COMPNY/EXECDR BUSREF/BIOS
Annual Report for 1992	Taxpayer Parent	NAARS/AR COMPNY/SEC,ARS
Taxpayer property in other states (for property factor or nexus issues)	Taxpayer Parent Affiliate	ASSETS/ALLOWN
Affiliates not included in the combined report	Taxpayer	COMPNY/SEC,10-K or 20-F
Transfer pricing information on the taxpayer's industry	Taxpayer Parent Competitor Product	MARKET/CMPNWS
Bankruptcy information	Taxpayer	COMPNY/BDS
Acquisition information	Taxpayer	M&A/ACQUIS

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Article in the San Francisco Chronicle on the taxpayer	Taxpayer	NEWS/SFCHRN CAL/ CANEWS,SFCHRN
Copy of B of E decision before hardcopy is distributed	Appellant	CAL/CASBE
Status of pending California legislation	Subject Bill No.	CAL/CABILL

Exhibit C lists some commonly used LEXIS libraries and files, and describes the content of those files.

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2460 Reports Of Privately Held Companies

If a company is privately held, it may or may not have supplied an annual report or certified statement to its shareholders. In most instances however, financial statements of some type will be furnished to either the shareholders or to a financial institution, which has provided funds to the corporation. Although these financial statements may not describe the business operations, the footnotes generally do include important information in regard to related party transactions.

Obtaining financial statements from privately held companies may be more difficult than from publicly held companies. If financial statements exist but the taxpayer refuses to supply the statements, the auditor should follow the standard steps recommended for failure to furnish information (MAPM 8040).

If an auditor believes that financial statements exist but has been told none were prepared, a review of the general ledger account "Legal and Accounting Fees" along with the supporting invoices can help identify if statements have been prepared.

Reviewed: December 2002

2480 Review Of Federal Tax Returns

Complete copies of the Federal Form 1120 tax returns (along with all supporting schedules) should always be reviewed during the course of the audit. Depending upon the level of detail contained in the California Form 100 return, it is often a good idea to perform this review during the preaudit phase. In some cases, the Federal 1120 and California 100 will be the same and no new data will be discovered. Most often, the Federal 1120 will contain detail that was not included in the California return. A company-by-company breakdown of income, balance sheet and M-1 data is necessary to perform the test checks and reconciliations discussed at MATM 2500. If not disclosed in the California return, that information can usually be found in the Federal 1120. A comparison between federal and state returns will also highlight any differences in income resulting from the taxpayer using different treatment for state and federal purposes.

When reviewing the Federal 1120s, the auditor should ensure that all the federal returns for the members of the combined group have been provided. This may include returns filed on Federal Form 1120-DISC, 1120-FSC or 1120F U.S. *Income Tax Return of a Foreign Corporation* (the 1120F is filed by foreign corporations with income effectively connected to the United States).

Form 851:

The California return will generally not contain the Federal Form 851 *Affiliation Schedule*. A review of this form is important because it contains the data needed to determine if there are any newly acquired domestic corporations or changes in stock ownership. Domestic companies, which have been sold, will be disclosed on the Federal Form 851 as well as on Schedule D.

Form 5471:

When auditing a domestic parent with foreign subsidiaries, the auditor should ensure that copies of any Forms 5471 filed by the taxpayer are provided along with the Federal returns. Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, can be a valuable source of income and apportionment data for foreign subsidiaries. This form contains information regarding income, balance sheet data, earnings and profits, stock ownership, distributions, federal subpart F income, and related party transactions involving the foreign subsidiary. This data will be useful for developing unitary information, preparing test combinations and factor reconciliations, and verifying dividend deductions.

Form 5472:

Form 5472, *Information Return of a Foreign Owned Corporation*, discloses information regarding a foreign-owned corporation's transactions with its foreign affiliates, and is useful for identifying unitary ties and intercompany transactions.

For federal purposes, Form 5472 is required to be filed by domestic corporations that have at least 25% direct or indirect foreign ownership, unless no reportable transactions exist (IRC §6038A). Reportable transactions generally include transactions between the domestic corporation and a foreign related party for monetary or nonmonetary consideration or for less than full consideration. Generally, most domestic corporations with a foreign parent will have a Form 5472 filing requirement for federal purposes.

For taxable years beginning on or after January 1, 1990, R&TC §19141.5 (formerly §25940) requires California taxpayers to file photocopies of the Federal Forms 5472 with the California return. (Note that this requirement only applies to *taxpayers*, not to members of the combined report that are not taxable in this state.) If the California taxpayers have failed to file all of the Forms 5472 with their state return, R&TC §19141.5 provides that a penalty of \$10,000 per required form might be assessed. See FTB Notice 1992-1 for information regarding an amnesty period for filing the form. Also note that the penalty may be waived for reasonable cause, or if the situation is deemed to fall under the penalty relief provisions of R&TC §21015 (effective for penalties imposed on or after January 1, 1996). FTB [Legal Ruling 96-3](#) provides examples of situations where FTB will, or will not, waive penalties under R&TC §21015.

NOTE: The Federal Forms 5471 and 5472 are informational returns that must be attached to the Federal Form 1120. Although the forms are used by the IRS during an audit, the Forms 5471 and 5472 themselves are not actually audited. Any adjustments found by the IRS are made to federal taxable income, not to the Forms 5471 and 5472. As a result, although the Federal Forms 5471 and 5472 may provide good leads for identifying issues, the accuracy of those forms cannot be relied upon without obtaining and auditing the underlying supporting workpapers.

Reviewed: September 2003

2490 Setting Up The Audit Workpapers

If the auditor has not yet begun to set up the audit workpaper package, this is the point where that task should be started. By setting up the workpapers very early in the audit process, cross-referencing can be done as soon as data is added to the file and as schedules are prepared. Immeasurable amounts of time will be saved during the audit if the auditor does not have to hunt around for the documents that support the adjustments or the figures that tie to the audit schedules. The end result is usually a much better organized file.

Cross-referencing is not only a time-saving device for the auditor, but it enables reviewers, hearing officers, attorneys and other users of the file to access the information to support the auditor's determinations. Without adequate referencing, information contained within the file may never be discovered. In addition, the users may not understand the purpose or significance of the documents that are found in the file.

When cross-referencing workpapers, the following guidelines should be followed to ensure that the information contained in the package will be easily retrievable for all users:

In addition to the overall index of the workpaper sections, any individual section with more than 10 pages should contain an index of the documents contained within that section.

If a document is important enough to include in a file, its purpose and source should be clearly explained. All documents should be labeled to identify: (1) the source of the document (e.g., the taxpayer's apportionment workpapers, the general ledger summary, etc.); (2) who provided the document; (3) the date received; and (4) what the information on the document represents. If the auditor verifies the information on the document (for example, if totals on the apportionment workpapers are traced to the financial statements), that fact should be noted. If the document is a schedule prepared by the taxpayer, the auditor should note whether it was prepared in the normal course of business, or whether it was prepared specifically in response to an audit inquiry.

This step is particularly important when corporations are reluctant to provide the information needed to perform the audit. By documenting when and how documents were obtained, evidence is present in the audit file to demonstrate that the taxpayer was not timely responding, or to support any failure to furnish information penalties.

All related documents should be cross-referenced to each other. For example, an IDR should contain a reference to the taxpayer's response, the response should be referenced to the IDR, and the appropriate program item should reference both the IDR and the response. As another example, audit schedules should reference the documents from which the figures were derived, and those documents should contain references to the audit schedules where the information is utilized.

When the taxpayer sends a letter with several documents attached, the letter should be included in the correspondence section, but the file is often easier to follow if the various documents are placed in the program item sections to which they relate. If the documents are separated, they should be cross-referenced to the letter. To maintain a proper record of what the taxpayer actually provided, a note should then be attached to the letter with a description or title of all separated documents and the workpaper number where they can be located.

Sometimes, a figure on an audit schedule will represent the sum of more than one number from a supporting document. For example, assume a document identifies the California sales of each division of Corporation X. Auditors may aggregate those figures, and carry the total to the audit schedules as "total California sales of Corporation X." In such a situation, merely referencing the supporting document may not be sufficient because the reader may not be able to figure out how the total was computed. The auditor should either prepare a supporting audit schedule to show how the figure was compiled, or should show the computation on a note attached to the supporting document.

References to a multi-page document such as an annual report are not very helpful unless the reference identifies the page, footnote number, etc. in which the relevant information is located. For example, the reference should indicate "1995 Annual Report, page 27, footnote 6."

Auditors should be careful when writing on significant original documents (such as letters from taxpayers) that may later be used as evidence in litigation proceedings. Markings on such documents may cause them to be inadmissible in court. In such cases, explanatory notes may be written on a separate page that is attached to the document. Alternatively, notes may be made on copies of the documents (but be sure to reference both the original and the copy so that readers are aware that both documents exist).

While the preaudit procedures are being performed, the auditor should keep in mind that copies of all documentation relevant to the audit issues should be included in the audit file. If it is later determined that an issue will not be pursued, any documentation that the auditor has already collected with respect to that issue can remain in the file with an indication that it has become irrelevant. This will save the auditor from having to re-request an item or re-perform an audit step if the information later becomes necessary for any reason.

Reviewed: December 2002

2500 PREPARATION OF PREAUDIT SCHEDULES

Information extracted from the federal and state returns, annual reports and SEC filings can be used to prepare certain schedules to highlight problem areas. Preparation of these schedules during the preaudit phase will help keep audit time to a minimum and enable the auditor to focus field time on reviewing taxpayer records rather than on setting up schedules. Many of these schedules are available on PASS.

- These preaudit schedules are:
- Summary of Returns (Form FTB 6860)
- Tax Effect Computations
- Test Check for Combination (Form FTB 6685)
- Book Income Reconciliation
- Analysis of Schedule M-1
- Property Factor Test
- Sales Factor Test
- Tests of Federal/State Differences

Reviewed: December 2002

2510 Summary Of Returns (Form FTB 6860)

This form is used to compare the computations of Net Income for State Purposes and the apportionment factors over several taxable years. By making this comparison, unusual fluctuations between the years can be easily identified and noted for further investigation. For example, if the Summary of Returns reveals that a state adjustment for excess depreciation was made for only one year, this will alert the auditor to the fact that special attention should be given to the review of the federal and state depreciation differences.

Reviewed: December 2002

2520 Tax Effect Computations

The tax change potential of a case is a key factor in justifying the commitment of department resources to a case. Usually, if an issue will not result in a material tax change in relation to the audit work that will be required to develop the issue, the lack of materiality should be noted in the file and the issue should be passed. During the course of the audit, the relative materiality of the audit issues will influence how the auditor allocates field time.

A Relativity Sheet (Form FTB 6861) is available that will indicate the amount of income or factor adjustment that will be necessary to generate a specified tax change. This form may be used as a guide to estimate the materiality of potential adjustments. Significant factor adjustments will have an impact on the materiality of income adjustments and vice versa, so care must be taken in using this form when multiple adjustments are considered.

Although the Relativity Sheet will assist the auditor in determining whether a potential adjustment will be material, it will not calculate the tax potential of a specific adjustment. A good way to calculate tax potential is to run potential adjustments through standard computerized audit schedules that have been set up using "as reported" income and factors. Again, it is important to remember that significant changes to income or factors (such as combination or decombination) will affect materiality of other issues. If combination or decombination is an issue, the auditor should consider determining the tax effect of other issues both ways (under the taxpayer's reported method of filing, and also assuming that the audit results in combination or decombination).

When calculating the materiality of issues, do not forget to consider the impact of variables such as the interest offset, NOL carryovers, and AMT effects.

Reviewed: December 2002

2530 Test Check For Combination (Form FTB 6685)

If a company is publicly traded, a quick check with Moody's, SEC 10-Ks, or a similar source will usually disclose whether all of the majority-owned affiliates have been included in the combined report. If the auditor determines that some affiliates have been excluded, and it appears that combination of those affiliates may be appropriate, Form FTB 6685 can be used to make a test check of the tax effect. A video search of the excluded affiliates (by corporation name) can be done to determine whether any of those affiliates are California taxpayers. In some cases, not all of the data necessary to calculate the income and factors is available during the preaudit phase (for example, payroll information is not always disclosed in the annual reports or 10-Ks). In order to test the tax effect of combination in those cases, the auditor may have to make estimates of the missing information based upon ratios, prior year information, or other reasonable methods.

If the tax returns (federal or state) disclose income and apportionment data on a company-by-company basis, the auditor may also be able to perform test checks for combinations that do not include the entire worldwide group, or for decombination of certain affiliates. This approach is particularly useful in determining the tax effect of decombining newly acquired subsidiaries (see MATM 3090 for a discussion of "instant unity"). These test checks may be computed by preparing the standard audit schedules using available information.

Reviewed: December 2002

2540 Book Income Reconciliation

A basic procedure for every audit is to reconcile the annual report income to the Schedule M-1 book income used in preparing the return. This reconciliation is *not* designed to reconcile book income to taxable income per the return. Instead, its purpose is to validate a starting point for the income computation. An analysis of the Schedule M-1 adjustments is only meaningful once the auditor is assured that the starting number is valid. Income reconciliations will also help to verify which entities' income has been included in the combined report, and may identify book/tax differences that have bypassed the Schedule M-1.

To perform this audit step, a reconciliation is made between the annual report book income and the book income used as a starting point on the Schedule M-1. The specific steps involved in performing this reconciliation are discussed in detail at MATM 5130. Although the auditor may sometimes need to examine the taxpayer's records in order to complete the reconciliation, in other cases the reconciliation can be prepared from data contained in the return and annual reports. It will therefore save time later on in the audit if this step is completed during the preaudit phase. Preparation of this reconciliation early in the audit is also important because it will identify how the taxpayer computed its income, and may highlight other areas that will need examination.

Reviewed: December 2002

2550 Analysis Of Schedule M-1

The Schedule M-1 adjustments should be analyzed, preferably on a company-by-company basis. The Schedule M-1 discloses the difference between book income and federal taxable income. If sufficient detail is disclosed in the tax returns, this analysis should begin during the preaudit phase.

Unusual Schedule M-1 adjustments should be examined, particularly if the IRS has not already audited the Schedule M-1. A Schedule M-1 item should not be ignored simply because it is small or appears to be in the State's favor. Taxpayers will often net positive and negative adjustments, so a seemingly minor adjustment may actually have very material components. It is therefore important to gain an understanding of what the Schedule M-1 items represent. Even if the IRS has examined the Schedule M-1, large, unfamiliar items should be explored to determine whether the adjustments are applicable for California purposes.

Frequently, Schedule M-1 adjustments relate to areas where state and federal treatment is also different (i.e., interest on municipal obligations, safe harbor leases, depreciation, etc.). The presence of these Schedule M-1 adjustments should alert the auditor to the fact that a state adjustment should also have been reported.

When an unfamiliar Schedule M-1 adjustment is noted during the preaudit stage, it may be helpful to consult a GAAP Guide to understand how the transaction was reported for book purposes. Financial statements of foreign parent operations will generally be prepared using the accounting principles of the home country rather than U.S. GAAP. The AICPA publishes a series entitled "*The Accounting Profession in (particular country)*" which summarizes the significant accounting principles of most major countries. Tax Management Portfolios and several "Big Five" accounting firms publish similar handbooks. These summaries will provide a good starting point for understanding how the financial statements have been prepared. Also see Exhibit J for general information regarding issues to look for when financial statements have been prepared under foreign accounting principles.

If research into the financial accounting treatment of the transaction does not resolve the auditor's concerns with respect to a particular Schedule M-1 adjustment, then the item should be flagged as a potential audit issue.

Further discussion of the Schedule M-1 analysis may be found in MATM 5140.

Reviewed: December 2002

2555 Property Factor Test

A test of the property factor denominator can be made during the preaudit phase if the combined group is the same as the consolidated group for financial statement purposes. To perform the test, beginning and ending property disclosed in the annual report or 10-K is averaged and compared to the average fixed assets reported on Schedule R of the return. Differences resulting from this reconciliation may be attributable to improper reporting of intercompany profits in fixed assets and inventories, construction-in-progress, etc. Any material differences should be pursued and resolved. See MATM 7110 for further discussion of property factor verification.

Reviewed: December 2002

2560 Sales Factor Test

If the combined group is the same as the consolidated group, the sales per the annual report should be compared to the sales reported in the denominator of the sales factor. Although there are valid reasons for differences, such as use of installment sale reporting for tax purposes, differences may also be attributable to failure to exclude intercompany sales, omission of sales from one of the entities, etc. If significant differences do exist, they should be pursued to determine if they are appropriate. See MATM 7505 for further discussion of sales factor tests.

Reviewed: December 2002

2570 Tests Of Federal/State Differences

Information available during the preaudit phase is often sufficient to enable the auditor to conduct preliminary tests to verify the reasonableness of various state adjustments. Techniques for verifying the various state adjustments are covered in MATM 6000 - MATM 6100. These sections should be referred to when material state adjustments are present, or when the auditor suspects that material adjustments should have been made.

Reviewed: December 2002

2600 DEVELOPMENT OF AUDIT PLAN

Once the preaudit procedures have been performed, a preliminary audit plan should be developed. The audit plan will form the basis for a decision whether to commit valuable department resources to the audit, and will help to ensure that the audit progresses as efficiently as possible. In addition to conserving department resources, an efficient audit plan will minimize the cost and inconvenience for the taxpayer.

The audit plan should list the potential issues that were identified during the preaudit stage, and should indicate the tax effect of each issue. If certain items on the returns appear to be questionable, but the tax effect of those issues does not justify their inclusion in the scope of the audit, this should be stated in the audit plan to avoid questions later on. The auditor should keep in mind that the issues defined in the audit plan are not set in stone. As the audit progresses, some issues will be resolved, and new issues may be identified.

After defining the preliminary audit issues, the general approach to the audit and the initial procedures and types of information that will be used to develop the issues should be planned. The auditor should give consideration to the order in which the issues will be examined. For example, since the income reconciliation and Schedule M-1 analysis often lead to the identification of other issues, they should be completed as early as possible in the audit. As another example, assume that a certain apportionment factor issue will only have material tax potential if the unitary examination results in combination. The auditor should therefore not spend a lot of time on the factor issue until they have a good idea of the direction that the unity issue will take.

A time plan should be developed for the fieldwork. This will allow the auditor to estimate the amount of time that will be needed at the taxpayer's location, and to determine how to most efficiently allocate that field time between the issues. When time at the taxpayer's location is limited, it is important that the auditor concentrate on the issues that have the most significance, and address the less significant issues as time allows.

The time plan should also take into account any statute of limitations constraints. Statutes of limitations are discussed in detail in the next section.

A sample audit plan for certain large cases selected by each office is described at MAPM 4070.

Reviewed: January 2004

2620 Statute Control

It is the auditor's responsibility to assure that statutes of limitations do not expire. Therefore, the auditor should review each return as soon as it is assigned to determine the statute. The earliest statute date should be noted and reviewed on a monthly basis, or as required by the statute check procedures used by the auditor's program office. Once a waiver has been executed to extend the statute for the earliest year, the statutes for all of the years should again be reviewed to identify the next earliest statute date. To avoid overlooking statute dates, particularly when several years or taxpayers are involved, a chart can be prepared to show at a glance the statute for each return.

Waiver policy: 1992 and subsequent years

In 1992, the terms and conditions of the Schedule R-7 "*Election to File a Unitary Taxpayers' Group Return*" were revised to clarify that a state SOL waiver signed by the key corporation would be binding on all members electing to be included in the group return. Therefore, beginning with taxable years filed with the 1992 Schedule R-7, auditors may obtain blanket waivers for taxpayers that were included in the original Schedule R-7 group return. The taxpayer name on the waivers should be shown as "*(key corporation) and Schedule R-7 Electing Members.*"

As long as a Schedule R-7 for 1992 or subsequent was executed, the blanket waiver will generally be acceptable even if the auditor is proposing to decombine the taxpayers or if one or more of the taxpayers has been sold. Judgement should be used of course -- if a taxpayer is asking to terminate their R-7 relationship, the auditor should obtain separate waivers to avoid potential problems. (Likewise, single notices can be mailed to taxpayers filing on a 1992 or subsequent Schedule R-7 regardless of whether a taxpayer has been decombined or sold, but the auditor should consider issuing separate notices if the taxpayer so requests.)

Separate waivers will be needed for taxpayers who did not file as part of the Schedule R-7 group return. If the audit includes returns from more than one R-7 group of corporations, the key corporation of each Sch. R-7 group must execute a separate waiver on behalf of that group.

Waiver policy prior to 1992

Prior to 1992, the terms of the Schedule R-7 did not include an express authorization by the taxpayers for the key corporation to sign waivers on their behalf. In order to avoid potential controversy, the department's waiver policy was revised to require auditors to obtain either separate waivers from each taxpayer in the combined report, or powers-of-attorney authorizing the corporation handling the audit to execute waivers on behalf of the other members. An exception to this policy is permitted if all of the following criteria are met:

The audit is not expected to result in decombination; *and*
all of the taxpayers are still affiliated with the key corporation; *and*

the key corporation is a California taxpayer qualified with the Secretary of State; *and* the key corporation is financially stable, has substantial net assets to pay the affiliates' deficiencies, and has not shown any indication that they would be unwilling to pay the affiliates' portion of the tax; *and* the key corporation has acted in good faith in fulfilling its obligations to pay under the terms of the Schedule R-7 in the past (i.e., they have not tried to terminate an R-7 relationship, refused to pay the tax of a combined subsidiary, attempted to disregard a waiver executed on behalf of a subsidiary, etc.).

If all of the above criteria are met, the auditor may accept a blanket waiver signed by the key corporation on behalf of taxpayers included in the Schedule R-7 election. Separate waivers must still be obtained from any taxpayers which have been disaffiliated or which are expected to be decombined. An explanation of how the above criteria were satisfied should be included in the audit narrative. Even if the above criteria apply, auditors should still consider obtaining separate waivers in cases where intrastate apportionment would result in a large potential tax liability being attributed to a taxpayer other than the key corporation.

Note: This policy applies to all pre-1992 taxable years with open SOLs, including years that are open under previously executed state waivers. However, for pre-1992 taxable years that are already under a blanket state waiver, the auditor may continue to accept a signature by the parent or key corporation on behalf of its affiliates. Although such waivers are still valid, if there is an open federal waiver the auditor should obtain separate state waivers in order to comply with the department's waiver policy.

Waivers should be signed by a principal officer (president, vice-president, secretary, treasurer, etc.) or duly authorized agent of the taxpayer. A tax manager is not often a principle officer, so before accepting a waiver signed by a tax manager (or other corporate official other than a principal officer), the auditor should obtain a power of attorney or other evidence that the corporation has duly authorized the official.

In lieu of repeatedly obtaining separate waivers from each taxpayer every time a SOL extension is needed, auditors may obtain a power of attorney from each taxpayer. If the taxpayers designate a common agent to sign the waivers, then single waivers can be obtained from that point onward. The FTB Form 3520 is a power of attorney form designed specifically for this purpose. If several taxpayers in a combined report have a principal officer or other authorized individual in common, then those taxpayers may use the form to execute a single power of attorney. In most cases, the appointee who is granted the authority to sign waivers should be the member of the combined report that is handling the audit.

See MAPM 9010 – MAPM 9110 for more statute information and instructions on securing waivers.

Reviewed: January 2004

2700 PRELIMINARY AUDIT APPOINTMENT

Although not technically a preaudit procedure, the preliminary audit appointment is appropriate for discussion in this section because it establishes the framework for the rest of the audit. The preliminary audit appointment should accomplish several purposes:

- The verification procedures set forth in the audit plan should be initiated;
- the questions and issues identified during the preaudit phase should be addressed (and resolved if possible);
- the auditor should become familiar with the nature of the taxpayer's business and accounting system; and
- the auditor should continue to be alert for new issues.

Reviewed: December 2002

2710 Initial Information Document Request

The specific information needed will vary depending upon the issues identified during the preaudit phase, the level of information obtained prior to scheduling the audit appointment (i.e., through annual reports, 10-Ks, Federal Form 1120s, etc.), prior experience with the taxpayer, and the planned scope of the audit. At a minimum, the following items should generally be requested:

Corporate minutes.

Workpapers used to compile the state adjustments and apportionment factor. The supporting workpapers will help the auditor gain an understanding of how the taxpayer computed its income and factors. **Important:** Such workpapers are *not* a substitute for books and records when it comes to verifying the figures reported on the return.

Consolidating workpapers used to compile the annual report. The consolidating workpapers may assist the auditor in completing the book income reconciliation and Schedule M-1 analysis. It will also show the intercompany eliminations made for financial statement purposes. The highest level of consolidation will often show enough detail. If not, copies of supporting workpapers should be obtained. Enough detail is needed to enable the auditor to determine income and eliminations on a company-by-company basis. Occasionally, taxpayers will consolidate on a basis other than by entity (by product line, for example). In such cases, the taxpayer should be asked how company-by-company information may best be obtained under their accounting system.

Chart of accounts. A review of a detailed chart of accounts may identify any intercompany accounts that are maintained and might also assist in determining the proper rent expense. The chart of accounts might also provide clues to help identify nonbusiness items.

Federal Forms 940 or 941 (list specific companies to be tested). The uses of these payroll reports are discussed in MATM 7310.

California DE-6's (list specific companies to be tested). The uses of these payroll reports are discussed in MATM 7310.

Federal Revenue Agent's Reports.

Complete Federal 1120s with all supporting schedules (including Forms 1120-DISC, 1120-FSC, 1120F, 5471s, 5472s, and 851s) (if not already obtained during the preaudit phase);

Annual reports and SEC filings (if not already obtained during the preaudit phase), or audited financial statements if the taxpayer is not publicly held.

Organizational charts or ownership charts. These charts may provide information that will be valuable in a unity examination. Even if unity is not an issue, an understanding of the organizational structure is helpful for identifying issues, analyzing intercompany activities, and providing some additional perspective on the case.

Record retention policy and an index. This will assist the auditor in determining what records are available, and titles of those records.

If unity is an issue, the taxpayer should be informed that a unitary investigation will be conducted. Information that should be requested in connection with a unitary audit is discussed at MATM 3500 - MATM 3595.

The letter to the taxpayer should make it clear that the scope of the audit is not limited to the information requested, and that additional information may be necessary.

Reviewed: December 2002

2730 Preliminary Discussion With Tax Department Personnel

The initial meeting with the taxpayer can have a significant impact on the entire information gathering process of the audit. An auditor who is not prepared is likely to be perceived by the taxpayer, as being incompetent and the taxpayer may therefore not furnish data as readily. Conversely, a well-prepared auditor is much more apt to obtain what is needed and in a much quicker fashion.

Preparation for the meeting should include becoming familiar with the annual report information and any other information obtained during the preaudit phase so those relevant questions can be framed.

There are many different approaches and styles that can be successful in the initial meeting. The auditor should generally use an approach with which they feel comfortable. A successful discussion will complete the auditor's orientation with the taxpayer by confirming, expanding or eliminating preliminary conclusions reached during the preaudit phase. The key areas that should be covered in the initial meeting are discussed in this section. Additional techniques are discussed in MAPM 5010.

Familiarization with tax department:

The auditor may begin the initial meeting by establishing the working environment and becoming familiar with the tax department personnel. The taxpayer should be asked to designate the person or persons who will receive the IDRs and who may be contacted to secure additional records or information. Turn around time for IDRs should also be discussed. The auditor should inquire about the location and accessibility of the records. It can be expected that records stored in a third party storage facility will take longer to retrieve than records stored in the basement of the taxpayer's premises. This information can assist the auditor in planning the completion of other audits in progress and avoid "down time."

Inquiring about who prepared the returns, how long they have worked for the company, and their experience prior to coming to the company will provide insight into the degree of expertise of the individual preparing the return. The level of knowledge that the tax preparer has with respect to apportionment matters may be a consideration in planning the scope of the audit. Knowing the number of tax department personnel and their general duties will provide insight as to whether the tax preparer is under a great deal of pressure to complete the return. If so, there is a possibility that adjustments or corrections, which would normally have been made, might be passed.

The tax department personnel should also be asked about the status of any protests or federal audit activity.

Nature of business, products, California operations:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

The auditor should use the preliminary meeting with the taxpayer to become familiar with the taxpayer's business, organization, personnel, record system, California operations, etc. The auditor should indicate a desire to learn about the taxpayer's operations and procedures in order to facilitate the audit with a minimum of time and effort expended by both parties. Rather than starting with general questions about the business operations, it is often a good technique to begin by asking the taxpayer to expand on the general statements made in the 10-Ks or annual reports. This approach will prevent the taxpayer from wasting his time commenting on information already available to the auditor. If this approach is not taken, the taxpayer may develop the idea that the information already supplied to the auditor was not properly reviewed.

Becoming familiar with the taxpayer's operations is a very important step in any audit. It is essential that auditors do not short cut this step by satisfying themselves with information gleaned from annual reports or similar documents. Even more importantly, auditors should not fall into the trap of assuming that they already know how the taxpayer operates based upon examinations of taxpayers with similar operations, or upon their general knowledge of the industry in which the taxpayer operates. Such assumptions quite often prove to be false, and in no event can they be relied upon to support an audit determination.

Plant tours:

If possible, the auditor should schedule a plant tour. Seeing the operations in progress is useful for identifying unitary ties. Questions about specialized machinery and the possibility of company wide usage, specialized processing or technical procedures, personnel transfers, and a host of other questions can readily be asked during a plant tour.

Accounting procedures and controls:

The auditor should become familiar with the taxpayer's accounting system. Is accounting centralized or decentralized? To what extent? Is it automated in regard to the apportionment factor? If so, how is the factor compiled and what audit trail is available? Are there standardized accounts and procedures throughout the organization? Is there one or more outside auditing firms? Are there intercompany transactions? If so, is there a flow of goods, financing, administrative or service charges; and how are they handled on the records? Most large corporations maintain a document retention index that lists the records or documents retained by the business, and identify the storage location. A copy of this index can assist the auditor in determining what records are available and what document titles to use in requesting the information. Reviewing the taxpayer's instructions for preparing the returns and correspondence with the accounting department might also be helpful.

Audit program:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

The taxpayer should be informed of the planned audit program or scope during the initial meeting. This does not necessarily mean revealing every single item that will be examined (although the auditor may prefer to use this approach). Generally, informing the taxpayer that the audit program will cover the unitary issue, state adjustments, the apportionment factors, etc. is acceptable. If any unusual items have been noted, these could also be mentioned. It should be explained that additional records might be required, and that the audit scope might be narrowed or expanded if unexpected problems arise. By presenting an open approach, without pre-judging issues, the auditor may avoid an early confrontation and a resistance to producing records.

Reviewed: January 2004

2800 PREPARATION OF AGREEMENT STATEMENT FOR TAXPAYER

An exception to the requirement of complete factual development for the current audit cycle applies if the taxpayer agrees with the adjustment. If the auditor develops an appropriate amount of preliminary information which indicates that an adjustment is likely to be appropriate, and the taxpayer is already in agreement, then there is generally no reason to put the taxpayer through the inconvenience of an extensive examination of the issue. In that circumstance, the auditor may ask the taxpayer to sign a statement confirming their agreement with the adjustment and with the preliminary facts that have been developed (this may include confirming the presence of facts developed in the prior year). For an example of the elements that should be included in such a statement, see Exhibit K. (Also see MATM 3520).

NOTE: It is important that the statement not be characterized as a "stipulation." A stipulation has a specific legal meaning, and binds both parties to a set of facts. The statements that auditors should be asking the taxpayers to sign are merely to confirm the taxpayer's representation of the facts and their agreement with the adjustment; they should not purport to bind the department to anything. Only in very rare situations would the department enter into any sort of bilateral agreement at the audit level, and only after the case has been evaluated by the Multistate Program Consultant and the agreement reviewed and approved by the Technical Resource Section and the Legal Branch.

If the taxpayer refuses to sign a statement confirming their agreement, then there is no assurance that the audit issue will not ultimately be protested. Therefore, the auditor must fully develop the facts.

Reviewed: December 2002